Regulation and governance of the firm

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This special issue of the International Review of Applied Economics brings together a number of papers that were originally presented at the 2006 workshop of the European Network on the Economics of the Firm held at the GREDEG, CNRS research institute of the University of Nice Sophia-Antipolis. The subject of debate at this workshop had the same focus as this special issue. Two key themes were apparent in workshop discussion: first, from an empirical perspective governance and regulation appears to be complex and multi-faceted, and that this complexity exists for sound reasons; and secondly, any analysis of firm governance and regulation that suggests a single, optimal set of structures and procedures is therefore inconsistent with this empirical observation. This introduction will develop the reasoning behind these two over-arching themes and in the process offer background to the detailed discussions in each of the papers.

The question of the 'locus of authority'

Perhaps rather predictably much debate on the topic of firm governance starts with the dominant or traditional economic approach informed by agency theory (Jensen, 1986; Jensen & Meckling, 1976). Within this framework owners are viewed as principals and managers (as agents) are accountable to these principals. The standard approach suggests that principals construct optimal incentives that control agent behaviour in line with owner objectives. It is then a short jump from positive principal-agent theory to a normative view that firms should maximise the value of shareholder capital. In concrete terms agency theory suggests a governance emphasis on (1) executive remuneration and (2) the structure and conduct of company boards. The first factor involves remuneration based on incentive realignment contracts at the heart of agency theory and the second is the infrastructure or means to constructing these incentive realignment contracts. But in addition, applied discussions on governance inspired by agency theory suggest an emphasis on an effective market for corporate control (Becht & al, 2005) to buttress these internal governance systems.

In the property rights approach to firm governance (Hart, 1995a,b) a link is created between shareholder control and residual rights i.e. the right to manage adjustment to unforeseen circumstances. These residual rights are different from the rights and responsibilities specified ex-ante in any contract. In this property rights view residual rights are allocated to minimise control costs. In addition such rights define ownership. The governance implications of this view are clear:

> There is in fact a strong argument that a market economy can achieve efficient corporate governance without government intervention… The company's founders have an incentive to choose an efficient corporate governance structure, that is one that maximises the aggregate return to all claimholders, at the time the company goes public… The reason is that as long as the founders sell the claims in a competitive market they will receive an amount equal to the (net) present value of the returns on all claims. They therefore have an incentive to choose corporate governance rules that maximise total surplus.
> [Hart, 1995b, p686]

In Tirole (1988) the ability to ex-post control adaptation to unforeseen events is characterised as authority; although Tirole does not link authority with ownership, a matter considered below. This theoretical strand is useful: it creates a link between agency based analyses of firm governance and a suggested shareholder 'locus of authority'. This shareholder locus of authority as the basis for governance discussion is also apparent in the transaction cost analysis of markets and hierarchies (Williamson, 1975). In a context of asset specificity, opportunism and frequent order, any organisational mode that is non-hierarchical will suffer from transaction cost inefficiencies. In short we can see a common theme running through much of the traditional approach to governance that emphasises an analysis based on an appropriate locus of authority. In addition, this appropriate locus of authority is viewed in terms of a dominant Anglo-Saxon governance system; although it will be argued shortly that this view of a single Anglo-Saxon system is an oversimplification of reality.

Shareholder locus of authority *versus* diversity in governance modes

The first major issue that can be raised about this shareholder locus of authority view of corporate governance is empirical evidence that suggests diversity of governance forms are important in practice (for example, Becht & al 2005; OECD, 2004; Carpenter, Lazonick &

O'Sullivan 2003; Grandori, 2004). This observation of governance diversity might suggest a conclusion that a single view of governance functioning based on locus of authority reasoning is inadequate given real-world governance activity. A characteristic way of describing governance diversity invokes different governance systems, for example Anglo-Saxon *versus* Continental European or Japanese (Aglietta & Rébérioux, 2005; Allen, 2005; Coffee, 2005; Lazonick & O'Sullivan, 2002; Aoki, 1984). The former being based on efficient finance markets and characteristic arms-length relationships between providers of finance and firms. The latter is frequently characterised in terms of a stakeholder view of the firm with non arms-length and interactive relationships (see also Blair, 1995; Donaldson & Preston, 1995; Kelly & al., 1997; Mitchell & al., 1997). This governance systems approach to diversity does not, in principle, undermine shareholder locus of authority reasoning. It is possible to argue that financial globalisation, and the resulting competitive pressures, is leading to a convergence of financial systems along the lines of an Anglo-Saxon model. But it is by no means obvious that a straightforward convergence is occurring. In his study of the evolution of governance and employment relations in US and Japanese corporations, Jacoby (2005) suggests that it is not possible to conclude that convergence to a single model is occurring.

While the existence of different governance systems cannot, by itself, undermine the significance of a single analytical perspective, a lack of convergence is suggestive that the shareholder locus of authority view of governance is inadequate as a complete explanation of firm governance. But a lack of convergence, by itself, poses a question but does not provide an answer. There would seem to be two ways of conceptualising the non-convergence of governance systems. The first uses, what might be called, a macro institutional reasoning. For example Jacoby (2005) refers to the "embedded corporation" to emphasise the point that all firms are embedded in a wider system of institutional arrangements. This institutional embededness of corporate functioning echoes the work of Commons (1995/1924) who suggested that we should understand the firm as a system rules, but rules that must be consistent with higher rules and macro institutions. Furthermore, if we follow the logic set out by North (1990) this embedded rules approach to governance will lead to path dependencies and long-run national growth disparities. Path dependent evolutionary processes will block any convergence and instead will determine institutionally specific comparative advantages.

While we accept that this macro-institutional blocking of convergence undermines a simple view of governance we wish to add to this reasoning a more complex picture. The second way of conceptualising the non-convergence issues is, we suggest, going beyond a view of 'governance systems' that have homogenous internal structure and functioning. For example, there has developed within US and UK financial systems a significant role for private start-up funding and venture capital. This start-up funding is, in general, not characterised by "Anglo-Saxon" arms-length relationships between financier and firm. Instead there is strategic intervention and an interactive relationship that is more characteristic of "bank based", "insider" corporate governance, or stakeholder European systems. Similarly significant technical and market change, with resulting new firm development, requires creative governance solutions in characteristic European systems (Aglietta and Rébérioux, 2005). The reason for this non-homogeneity is not difficult to identify: the complexity of firm governance is in general too great to rely on single homogenous structures and processes. The governance system itself must be at least as complex as the environment it is controlling. Why the environment might be viewed as complex is a matter considered below, when this complexity is directly linked to the inadequacy of shareholder locus of authority reasoning. Hence as a general principle we wish to emphasise that governance systems are internally complex rather than homogenous, if they are to be generally effective. But equally we reject the possibility of convergence of complex systems because of institutional specificities and path dependencies.

Shareholder locus of authority *versus* governance failures

In addition to general observations about the diversity of governance systems a second set of empirical issues has led to the questioning of locus of authority reasoning, namely governance failure. Significant discussion has concentrated on Anglo-Saxon cases of failure and corporate corruption (for example the US case of Enron). But equally governance failure and corruption has occurred in Europe (for example Parmalat). This background diversity suggests there is no simple explanation. But take, for example the view expressed by Stiglitz (2003, p 244):

> Enron and its accountants sometimes stepped over the line, but much of what Enron did was legal…. Enron used accounting tricks that were increasingly becoming standard. It appears that its chief financial officer made the same discovery that so many other corporate executives made during the nineties: the same accounting tricks that could be used to distort information to boost stock market prices could be used to enrich themselves at the expense of other shareholders.

There are two key issues to notice in this quotation. First corrupt practices were apparently widespread i.e. there is a system rather than company specific problem. Secondly, emphasis is placed on accounting failures. Admittedly this accounting failure explanation is combined by

Stiglitz with two other factors: an important role for deregulation policies that Enron exploited; and secondly linkages between Enron and government agencies. But Stiglitz's interpretation is that Enron bought itself into these agencies, and exploited the positions involved, because of malign intent. By implication, remove the malign practices (by removing accounting failures) and the problem is solved. In short we seem to be able to rely on a locus of authority view of governance – as long as it works properly.

But there are, arguably, strong reasons why accounting failure might be a necessary but not sufficient account of governance failure. Sufficiency would require us to recognise the shortcomings of the shareholder authority perspective. The main problem with an optimal incentives or agency failure view of corruption is that effective external detailed control of managerial behaviour is in general not possible in the corporate sector. This control requires that managerial behaviour is constrained and enabled in a predictable manner. But to constrain and enable behaviour in this manner requires external agents having knowledge of (a) company transformation processes and (b) managerial preferences. These knowledge assumptions lie at the core of the theory of optimal incentives. The fact that managerial preferences are non-observable is perhaps obvious given the subjective nature of individual preferences and the necessary assumption of instrumentally rational agents. Hence, in practice incentive systems might be based on assumed and stereo-typically standard behaviour. It may, of course, be the case that the incentive system causes the assumed behaviour i.e. the reverse of the logic that economists assume. This reverse logic is consistent with more sociological views of institutional functioning that view institutional forms as widespread because they are viewed as appropriate and legitimate, not because they are optimal. Di Maggio & Powell (1983) explicitly reject the view that institutional isomorphism leads to efficiency, arguing instead that isomorphism leads to efficiency because relations must be viewed as legitimate before they are possible. This logic seems feasible when managerial preferences are not only not observable but also created by the incentive systems that are characteristically used. Within economics this reasoning is consistent with work that suggests the "framing" of problems affects decisions (Kahneman & Tversky, 1979, 1984).

Shareholder locus of authority *versus* governance of knowledge

So while standard agency assumptions about knowledge of managerial preferences seem to be somewhat artificial or extreme, given the analysis of governance, what about knowledge of company transformation processes? It is undoubtedly true that financial institutions invest considerable time and resources into analysis of market and industrial trends. But is this the same as adequate knowledge of individual company processes? It is not uncommon in branches of economics that emphasise the importance of product market evolution and change to base analysis on firms with idiosyncratic competences. For example much of this work uses the seminal writing of Penrose (1959), Richardson (1972) and Nelson & Winter (1982). From this perspective knowledge of company transformation processes are non-communicable, but instead are largely tacit. To acquire such knowledge requires learning by doing involving actually undertaking the transformation processes themselves. By definition external owners therefore cannot acquire such knowledge, even if the external owners are large financial institutions (O'Sullivan, 2000; Foss & Christensen, 2001; Krafft & Ravix, 2005, 2008; Rajan & Zingales, 2001).

There would seem to be two ways of rescuing locus of authority governance from the required knowledge assumptions (ignoring the issue of managerial preference creation). First, we can suggest that governance of this type is relevant to activities in which idiosyncratic competences are unimportant. In this case any average, ex-post knowledge of market and industry characteristics is a useful and relevant guide to the performance of firms within these markets. But clearly this relevance of average knowledge is not universal, and in particular becomes increasingly less relevant as individual firm competences become more important for competition. An important indicator of this increasingly irrelevance of average data is the development of stock market speculative bubbles. These appear to be characteristic of economic circumstances and sectors that exploit technological and institutional innovative revolutions (Perez, 2002). In these circumstances individual firm competences are key to performance and average knowledge is largely irrelevant (Fransman, 2004).

The second way of rescuing locus of authority governance is more analytical in focus and involves recognising its partial equilibrium characteristics. This reasoning is evident in agency theory, property rights analysis, and Williamsonian transaction cost economics (Hodgson, 1993; Lawson, 1994, Dietrich, 1994). It follows that locus of authority reasoning need only be relevant in steady state circumstances. This is basically the same point as that just made as in a steady state average data is an accurate indicator of underlying activity. Two implications follow from recognising the partial equilibrium basis of locus of authority reasoning. First, any change to the system is viewed as a response to an exogenous shock. For example, with respect to governance, one such shock might be state inspired regulatory reform to which firms respond. But what is not part of this partial equilibrium analysis is the possibility that the external shocks need not be strictly exogenous, but instead part of firm strategy. The second characteristic of partial equilibrium reasoning is the well recognised issue that process matters are marginalised or ignored. Related to this is the standard critique that there is no comment on the length of time involved in shifting between equilibria. In terms of earlier discussion this involves the length of time that idiosyncratic competences are core to firm strategies. If we accept the input from management based writing (for example Hamel & Prahalad, 1994) continuing competitive success requires the continued upgrading of unique competences i.e. the process is all that matters.

Implications on governance

Where does this critique of locus of authority reasoning lead to in terms of discussion of corporate governance. A fundamental point is that standard reasoning cannot be universally applicable. But equally it need not be irrelevant in some circumstances. To complement this standard reasoning we must move beyond a universal view of governance that is restricted to a single principal or a single locus of authority. This is hardly an original comment (Grandori, 2004). Even if we accept that shareholders are in some sense the only real principal for firm activity (a claim contested in a moment), owners do not constitute a single locus of authority. As is also not original we can identify atomistic, individual owners as fundamentally different compared to institutional owners. This is the case for at least three reasons: possibly different time horizons; different attitudes to risk; and different capacities to absorb the transaction costs associated with share ownership (for example Schleifer & Vishny, 1997). But these differences only have economic significance if they are institutionalised i.e. if the different institutional needs are recognised. To some extent this different institutional need is apparent. For example, small shareholders have separate collective bodies compared to institutional owners. But beyond this shareholders are viewed as a single locus of control.

Within formal principal-agent theory there have been attempts to introduce multiple agents (see, for example Laffont & Martimort, 1997). Bernheim & Whinston (1986) suggest that ‘common agency’ may be significant. Examples of common agency fall into one of two categories: delegated or intrinsic. Delegated common agency arises when several parties voluntarily bestow the right to make certain decisions upon a single (common) agent. Intrinsic common agency arises when an individual is "naturally" endowed with the right to make a particular decision affecting other parties, who may in turn attempt to influence that decision. Both possibilities involve a number of principals who simultaneously announce incentive schemes for a common agent. In the presence of collusion institutional remedies for the resulting inefficiency are needed. In addition the distribution of net rewards among the principals is, in general, indeterminate when we have common agency. This indeterminacy suggests that actual allocation of rents depends on, among other things, how the relationships are institutionalised.

But the importance of multiple principals goes beyond the identification of different owners. It was emphasised earlier in this introduction that, apart from the special case of a steady state, organisational knowledge issues become important for governance. Hence as a general rule, governance issues have to deal with locus of authority and locus of knowledge matters. Organisational decentralisation of knowledge management is a standard requirement for effective competence development in anything other than very small firms. The reason for this decentralisation follows from Simon's (1962, 1965) observation about decomposability and management of complex knowledge. To orient thinking we can think of two extreme possibilities. When competence development is unimportant, governance only has to deal with locus of authority matters. This is the standard perspective on governance. With authority defined as above i.e. the ability to manage responses to unanticipated events. If we can imagine a world in which ex-ante management of knowledge is the only requirement for organisational activity a locus of authority would be unnecessary. But the knowledge decentralisation, and the resulting organisational team activity, still produces coordination problems. The solution to these coordination problems cannot be centralised because knowledge management cannot be centralised. The only real solution is to view organisational activity as a "stakeholder" bargaining problem (see Aoki, 1984). Here the organisational team coordination problem can be viewed as involving agents that control organisational knowledge bargaining over the allocation of organisational rents. The real world, of course, will lie (as a general rule) between these two extremes. In short corporate governance involves the interaction between locus of authority and locus of knowledge. Inevitably this involves some degree of stakeholder management if competition is based on competence development. If this perspective is accepted, the view of different governance systems (as discussed above) can be viewed as different characteristic ways of institutionalising the interaction between locus of authority and locus of knowledge.

Implications on regulation

One final comment would seem to be appropriate. The opening title of this introduction made reference to firm governance and regulation. Up to now we have considered issues to do with governance. If we have a steady state perspective, in which a locus of authority is the only relevant issue for governance the distinction between governance and regulation is straightforward to identify. Regulation involves the legal and other institutional structure that is common to all firms. If we imagine the opposite governance extreme that was considered above in which only ex-ante knowledge management takes place, the distinction between governance and regulation can be considered. In principle the knowledge base for any one individual firm may require inputs from non-organisational actors e.g. suppliers, distributors, and state agencies. Using the earlier logic these non-organisational actors become stakeholders and as such are part of the governance coordination problem. This involves a lack of clarity about the distinction between governance and regulation. For example, if a state agency is offering knowledge or services to all firms this can be considered part of the regulatory structure. But if state agencies offer knowledge or services to individual firms the relationship is that of organisational stakeholder. Between these two the distinction is unclear and this lack of clarity has important economic implications. Outside of a steady state the institutional, and other, environment within which a firm operates is (potentially) subject to strategic influence. A stakeholder relationship might be important in the management of this influence. In short there may be strategic advantages in the blurring of the distinction between governance and regulation.

Outline of the special issue

The papers presented in this special issue take up different aspects of the general issues raised above, and collectively stress the complex and multi-faceted aspects of governance and regulation that render the reference to a single, optimal set of structures and procedures often inconsistent. Michel Aglietta develops a team theory of the firm that defines corporate governance as a coordination game and the crucial role of the Board of Directors as an integrator of stakeholders' interests. The paper shows that the coordination game has multiple stable solutions, leading to diverse modes of governance. The outcome of the game depends on the power structure within corporations, which in turn is linked to the dominant pattern in the financial system. Blanche Segrestin and Armand Hatchuel raise that the convergence towards a unique model of corporate governance tends to leave aside collective activities and their value creation processes. Coordination, capabilities development and innovation are then omitted in the prevalent representation of the corporation. They argue that the concept of the firm should be distinguished from its corporate forms. Going back to the basic nature of the firm, they suggest that a firm is a collective endeavour whose activities are directed by management to create new potentials. Cécile Cézanne-Sintès rediscovers the link between the nature, boundaries and governance of the firm on the basis of changes in corporate industrial firms. She argues that this analytical interconnection should be restored to understand the human capital-intensive firm. She develops a 'multi-resources' model of governance of the firm that depends on an original representation of the structure, organisation and power relationships of modern firms, whose value arises from the accumulation of specific human capital. Jacques-Laurent Ravix argues that a reappraisal of the nature of the firm is necessary to analyse firm governance. Based on Austrian and Marshallian approaches, he considers the firm as a processor of production and knowledge, whose governance is implemented through the cooperative actions of stakeholders involved in a collective learning process. Divergences with models of corporate governance based on shareholder-value principles are underlined. Cristiano Antonelli, Pier-Paolo Patrucco and Francesco Quatraro show that knowledge externalities do trigger increasing returns that are external to each firm only within a well defined interval. Knowledge externalities are a property of the system into which firms are embedded. The quality of knowledge governance mechanisms in place plays a key role in assessing the actual size of the net positive effects of knowledge externalities, leading to different forms of firms governance. Albert Jolink and Eva Niesten refer to transaction costs economics, and address the questions of whether European electricity regulation has led to the prospected outcome of governance transformations to the market and whether and how the attributes of transactions adapt to the altered forms of governance. On the basis of the Dutch electricity industry, they find that the market forms of governance did not emerge, the attributes of the transactions are relatively stable, and that regulation at most has led to second-best governance solutions. Elizabeth Spencer outlines the use of disclosure in the regulation of the franchise sector in Australia, demonstrating that it does not meet conditions considered necessary for effective informational regulation. Increased cooperation among and fuller representation of stakeholders, better information from dispute resolution processes, and registration of disclosure would improve the level of information about the sector generally. She surveys other regulatory tools, but urges that these tools be selected as part of a participative regulatory process that accurately represents the interests of all stakeholders.

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